Alberta Heritage Savings Trust Fund

BUSINESS PLAN 2007-10

Table of Contents

Introduction 333

Mission 333

Background 333

Fund Governance 334

Goals, Strategies and Performance Measures 335

Risks to Achieving Goal and Performance Measures 337

Income and Expenses 338

Risks to the Investment Income Forecast 338

Appendices

A: Return and Asset Mix Assumptions 340

B: Definitions of Benchmark Indices 340

C: Definitions of Terms Used in the Business Plan 341

The Business Plan was reviewed and approved by Treasury Board on February 21, 2007, and by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund on March 5, 2007.

INTRODUCTION

This is the eleventh* business plan for the Alberta Heritage Savings Trust Fund (Heritage Fund), which amends the previous business plans and incorporates updated financial information and income forecasts. The plan sets out specific investment objectives, goals and strategies to achieve the Heritage Fund's objectives as expressed in the legislation.

MISSION

To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.

BACKGROUND

- The Heritage Fund was created in 1976 to save a portion of Alberta's non-renewable resource revenue. From inception until 1987, the government set aside part of the Province's oil and gas revenue in the Fund. Since 1982 income from the Fund has been transferred to the General Revenue Fund and, to date, about $30 billion of investment income has been made available to fund government priorities such as health care, education and infrastructure.

- On January 1, 1997, the Heritage Fund was restructured in response to a public review and the Fund is now managed as an endowment fund with the goal to maximize long-term returns at an acceptable level of risk. The restructuring included a new governance model as well as the establishment of new investment objectives and performance measures. The Fund is not to be used for economic development or social investment purposes.

- Past public consultations have confirmed the importance of the Heritage Fund as an endowment, underscoring the need to preserve its real value over the long-term. The *Alberta Heritage Savings Trust Fund Act* includes an inflation-proofing provision requiring a portion of the Heritage Fund income to be retained to protect its real value. Regular inflation-proofing of the Heritage Fund started in 2005-06 once the Province's accumulated debt was eliminated.

- The Fund consists of investments in bonds, equities, real estate, derivatives and alternative investments such as private investments and timberlands. The Fund's assets are prudently managed with a long-term focus. The assets of the Heritage Fund are invested globally with allocations to Canada, the United States, Europe, Asia, and the Far East.

- Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the Province. All income earned during a fiscal year, except for amounts retained for inflation-proofing, is transferred to the Province's General Revenue Fund and is used to pay for government programs and services.

- In 2006-07, income of the Heritage Fund is forecast to be almost $1.8 billion. Of this amount, $202 million will be retained in the Fund to provide the inflation-proofing required by legislation and the balance of almost $1.6 billion will be transferred to the government's General Revenue Fund.

Note:

* This number was corrected subsequent to the release of the printed version of this document.

- The fair value of the Heritage Fund is forecast to be $16.3 billion at March 31, 2007, up from $14.8 billion at March 31, 2006. In addition to growing by $585 million due to inflation-proofing, the value of the Fund has increased over the past two years as a result of a total of $3 billion in deposits made by the government. In each of 2005-06 and 2006-07, the government deposited $1 billion from the surplus into the Fund. The government also made contributions of $750 million in 2005-06 and $250 million in 2006-07 into the Heritage Fund on behalf of the Access to the Future Fund*

FUND GOVERNANCE

The Minister of Finance is responsible for the management and investment of the Fund and is required to report on the performance of the Fund within 60 days of the end of each quarter and make public the annual report within 90 days of the end of the fiscal year. The Minister of Finance prepares the business plan and presents it for approval to Treasury Board and the Standing Committee on the Alberta Heritage Savings Trust Fund.

When investing the assets of the Fund, the *Alberta Heritage Savings Trust Fund Act* requires the Minister to adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return.

The *Alberta Heritage Savings Trust Fund Act* requires there to be a Standing Committee on the Alberta Heritage Savings Trust Fund, which has representation from the major parties of the Legislature. The Standing Committee reviews quarterly reports and approves the business plan and annual report of the Fund. The Committee also reviews the performance of the Fund after each fiscal year end and reports to the Legislature whether the mission of the Heritage Fund is being fulfilled. The Standing Committee also conducts public meetings on an annual basis in different locations in the province. The purpose of these meetings is to update Albertans on the management of the Fund, answer questions and solicit input on its objectives.

The Minister of Finance established the Endowment Fund Policy Committee in 2003, adding private sector advice to the formulation of the Fund's investment policies. The Committee reviews and makes recommendations to the Minister of Finance with respect to the business plan, annual report and investment policy statements of the Fund. The Committee meets regularly to review performance and fund management.

The Heritage Fund is managed by Alberta Investment Management, a group of qualified and experienced professionals in Alberta Finance, according to the investment policies set out by the Minister of Finance. External specialized private sector investment managers are used to manage specific investment mandates. Alberta Finance is currently in the process of converting Alberta Investment Management into a provincial corporation. The anticipated benefits of a provincial corporation structure include stronger organizational governance, increased operational flexibility and a more focused strategy resulting in an expectation of higher investment performance.

The business plan of the Heritage Fund is published as part of the provincial budget.

The Auditor General is the auditor of the Heritage Fund.

Note:

* The Access to the Future Fund was created by the government in 2005-06. The money contributed to the advanced education endowment within the Heritage Fund is invested with other Heritage Fund assets. Earnings from the principal amount go to the Access to the Future Fund administered by the Minister of Advanced Education and Technology and are used to provide seed money for innovations in the post-secondary system, matching grants to stimulate private, industry, and other contributions to the advanced learning system.

GOALS, STRATEGIES AND PERFORMANCE MEASURES

GOAL ONE 1 Maximize long-term returns at an acceptable level of risk while preserving the real value of Heritage Fund assets

What it means Investment income from the Heritage Fund is an important component of the government's fiscal plan. All Fund income, except for amounts retained for inflation-proofing, is transferred to the General Revenue Fund and used to fund Albertan's priorities. The Fund must be invested in such a way as to maximize returns without taking undue risk. It is widely accepted that a prudent mix of fixed income securities, Canadian and foreign equities, real estate and alternative asset classes best achieves the objective of optimizing financial returns and diversifying risk.

The *Alberta Heritage Savings Trust Fund Act* provides for the maintenance of the Fund's real value by requiring the Heritage Fund to be inflation-proofed.

Strategies

1.1 Implement the policy asset mix as per the Heritage Fund's Investment Policy Statement, as shown in Table 1. This policy asset mix provides for increased investments in the private equity and private income asset classes to improve risk/return trade-offs.

1.2 Periodically review investment policies to ensure new products are considered and that the asset mix remains appropriate under the prevailing market circumstances.

1.3 Actively manage the Fund with the objective of adding value above the benchmark portfolio without assuming undue risk. This could include a variety of strategies such as derivatives-based strategies.

1.4 Vary the allocation among asset classes based on the manager's market views to enhance returns.

1.5 Inflation-proof the fund by retaining a portion of Heritage Fund income equal to the starting value of the Fund at the end of the fiscal year multiplied by the percentage increase in the Canadian gross domestic product price index. This will allow the Heritage Fund to grow with inflation over time.

Performance Measures[1]	Last Actual 2005-06	Target 2007-08	Target 2008-09	Target 2009-10
One Year Performance	CPI plus	CPI plus	CPI plus	CPI plus
• Asset mix return[2]	11.6%[5]	4.5%	4.5%	4.5%
• Active management return[3]	1.40%	0.60%	0.75%	1.00%
Five Year Performance[4]	CPI plus	CPI plus	CPI plus	CPI plus
• Asset mix return[2]	11.6%[5]	4.5%	4.5%	4.5%
• Active management return[3]	1.40%	0.53%	0.59%	0.67%

Notes:

1 All returns are net of fees unless otherwise noted.

2 Asset mix return is used to determine whether the asset mix as set out in the Investment Policy statement is achieving expected returns. The asset mix return is measured by calculating the returns the policy would have delivered without active management.

3 Active management return is used to measure the impact of active fund management on investment performance. It is calculated as the difference between actual investment returns and the asset mix return.

4 Calculation of this performance measure began in 2005-06 and is being phased in for the future years. Accordingly, the actual results reflect the performance from 2005-06 alone.

5. Total return for the fiscal year was 15.4% while the asset mix return was 13.8 per cent. The Consumer Price Index rose by 2.2 per cent during the fiscal year.

TABLE 1: Current Policy Allocation and Benchmarks

Allocation	Policy Benchmark[1]	Actual Asset Mix at Dec. 31, 2006[2]	Long-Term Target Asset Mix
Cash & Absolute Return Strategies			
Money Market	Scotia Capital 91-Day Treasury Bill	0.3%	1.0%
Absolute Return Strategies	HFRX Global Investable Index – Hedged C$	4.8%	5.0%
Fixed Income			
Public Fixed Income	Scotia Capital Universe Bond Index	29.8%	29.0%
Inflation Sensitive			
Real Estate	Investment Property Databank Large Institutional Property Index	10.2%	10.0%
Private Income[3]	CPI + 6%	1.1%	4.0%
Timberland[3]	CPI + 4%	0.3%	2.0%
Equities			
Canadian	Standard & Poor's / TSX Composite Index	16.3%	15.0%
US	Standard & Poor's 1500 Index	17.7%	15.0%
Non-North American	Morgan Stanley Capital International Europe, Australasia, Far East	17.2%	15.0%
Private Equity[3]	CPI + 8%	2.3%	4.0%
Total		**100.0%**	**100.0%**
Overlay Strategies			
Active Currency Overlay[4]		0.2%	5.0%
Absolute Return Strategies Overlay[5]		3.5%	5.0%

Notes:

1 Descriptions of the benchmarks are shown in Appendix B.

2 Asset mix is shown on an accounting basis.

3 Higher allocations to private income, private equity and timberlands will be subject to the availability of attractive opportunities.

4 Allocations to active currency overlays are shown as targeted notional exposure. These strategies have notional exposure to various currencies, but generally have near zero net exposure.

5 Absolute return strategy overlays are investments in absolute return strategies that are used in conjunction with public equity indices to enhance portfolio returns.

RISKS TO ACHIEVING GOAL AND PERFORMANCE MEASURES

If the Fund's income is less than expected the government fiscal plan will be affected. Similarly, if the Fund fails to earn enough to keep pace with inflation, its real value will fall. Investment returns and income will vary significantly from year to year, and may underperform investment expectations for extended periods of time for the following reasons:

- The well-established capital market principle is that increased expected returns are accompanied by increased risk. However, it does not always follow that increased risk enhances return. Diversification among various asset classes lowers but does not eliminate the risk of loss.

- An investment policy to maximize long-term returns implies a higher weighting towards equities. Equities have historically provided investors with higher total returns (dividends and capital gains) than fixed income investments. However, dividend yields in general are lower than interest rates, so an equity portfolio will provide lower current income while the magnitude and timing of capital gains are uncertain. Equity markets have had negative returns in the past.

- A well-implemented private equity portfolio can provide investment returns above those of public equities. However, by their nature, private equity investments are significantly riskier than public equity investments and are associated with an investment horizon of five to ten years to realize investment gains. Some private-equity investments are subject to potentially large or total investment loss.

- Private income investments (e.g., infrastructure investments, bridge loans, and other corporate financing arrangements) provide current income, diversification and an inflation hedge. However, these types of investments are subject to a number of risks, including illiquidity, loss of principal and reduced income.

- Absolute return strategies have gained prominence in recent years with an expectation of stable returns. However, this market is very fragmented with investment fees above those of traditional managers. In some cases there have been large losses sustained in the industry by otherwise well-informed and highly professional investors. Manager selection and oversight are therefore critical to successful implementation.

- In the implementation of the Fund's investment policies, the manager will use a variety of investment strategies, including short selling. Short selling involves borrowing and selling a security, basket of securities or an index that one does not otherwise own. Shorting is used to hedge positions, provide liquidity and enhance returns. Short selling introduces a number of issues including leverage, risk management, market risk and operational complexity. The risks of an investment strategy, including short selling, are mitigated by adherence to investment policies and internal controls, strong risk management, and oversight by management.

GOAL TWO **2** **Ensure the transparency of the Heritage Fund's objectives and results for Albertans**

What it means Published reports and news releases will provide Albertans with access to understandable information to enhance awareness of the Heritage Fund.

Strategies

2.1 Release quarterly and annual reports on a timely basis in simple, understandable language.

2.2 Release summary reports of the Heritage Fund's investment activities and results for Albertans on a timely basis.

2.3 Publish the Heritage Fund Business Plan annually.

2.4 The Legislature's Standing Committee holds annual public accountability meetings around Alberta to report on the Heritage Fund's results and to answer questions on the Fund's performance.

Performance Measures under development

- Timeliness of reports and public accountability meetings.
- Annual report will be released by June 30 of each year.
- Quarterly reports will be released within two months after the end of the quarter.

INCOME AND EXPENSES

TABLE 2: Heritage Fund Income Forecast

Forecast Annual Income ($millions)	2006-07	2007-08	2008-09	2009-10
Unconsolidated investment income	1,753	1,219	1,224	1,310
Amounts retained for inflation-proofing	202	284	305	311
Transfer to General Revenue Fund	1,551	935	919	999
Forecast fair value of the Fund ($ billions)	**16.3**	**16.5**	**17.0**	**17.3**

The Heritage Fund income forecast is supported by the assumptions shown in Appendix A.

- The income forecasts include interest income, dividend income and realized capital gains or losses.

- Capital gains and losses on traditional investments are not recognized as income until the investment is sold or, given a significant loss that is expected to be permanent, is written down. Therefore, gains and losses that are included in reported market value rates of return may not be immediately reflected in income reported in the financial statements. (In the case of equity index swaps and futures contracts, gains and losses are realized in income as they occur).

- The Heritage Fund records investments at cost, which exclude unrealized gains and losses. The fair value of investments is provided for information purposes. The Canadian Institute of Chartered Accountants public sector accounting standards regarding the accounting and reporting of financial instruments at fair value for governments are currently under review.

- Actual income and fair value results will vary from projections based on the extent to which actual market returns and interest rates vary from the assumptions used.

RISKS TO THE INVESTMENT INCOME FORECAST

- Fund income is dependent on both cash income (e.g. from dividends and interest) and realized capital gains (losses). Although cash income is relatively stable, capital gains are uncertain and subject to large variance.

- If equity returns are lower than assumed, investment income could be lower because stocks in the Fund could be sold for smaller gains than anticipated, or possibly for losses, depending on the extent of turnover in the various equity portfolios.

- If interest rates go up, the market price of bonds held by the Fund would typically decline. Sales of these bonds would produce smaller gains than expected, or, perhaps, losses, depending on the amount and timing of turnover in the portfolio.

- There are other risks in the portfolio including exchange rate movements and commodity price changes. The Fund has investments in foreign assets such as U.S. equities which are not hedged into Canadian dollars. If the Canadian dollar were to appreciate then this would detract from return. The Fund also has investments in commodity based securities such as timberland, which are sensitive to fluctuations in commodity prices.

TABLE 3: Heritage Fund Expense Forecast[1]

Forecast Annual Expenses ($millions)	2006-07	2007-08	2008-09	2009-10
Direct management costs	2.6	2.7	2.7	2.8
Externally-managed investment pools	51.8	59.9	66.3	71.4
Internally-managed investment pools	5.3	5.7	5.9	6.0
Total	**59.7**	**68.3**	**74.9**	**80.2**
As a percentage of fair value	0.37%	0.42%	0.44%	0.46%

Note:

1 Due to factors such as differences in assumed and actual experience in asset class allocations and growth in the size of the Heritage Fund, actual expenses may differ from forecast expenses. Forecast expenses do not include external manager performance fees. The forecast reflects a change in methodology as compared to prior years' business plans. Most notably, expenses in certain alternative asset classes have been forecast based on committed capital. In 2007-08, a new cost system will be used to report Heritage Fund expenses.

- After fees, active management of the Fund produced approximately $190 million in 2005-06.

- Administrative expenses include both direct and indirect administrative expenses, which include staff time, supplies and services, investment service costs and advisory services.

APPENDIX A:

Return and Asset Mix Assumptions

Long-Term Capital Market Rate of Return Expectations	
Canadian public equities	7.00%
Foreign public equities	8.00%
Real estate	7.00%
Private investments	9.70%
Timberland	7.80%
Absolute return strategies	6.00%

Budget Assumptions	2006-07	2007-08	2008-09	2009-10
10-year bond rate	4.15%	4.25%	4.50%	4.75%
C$/US$ exchange rate	.8790	.8600	.8690	.8700

Asset Mix Weights[1]	
Money market	1%
Absolute return strategies	5%
Fixed income	29%
Real estate	10%
Public equities	45%
Private investments	8%
Timberland	2%

Note:

1 The assumptions for 2006-07 reflect the average asset class weights assumed by the forecast model, which take into account actual experience to December 31, 2006 and the asset mix policy delineated in the 2006-09 Business Plan.

APPENDIX B:

Definitions of Benchmark Indices

Consumer Price Index

Measures the rate of inflation in Canada as published by Statistics Canada.

HFRX Global Investable Index (Hedged C$)

An index maintained by the Hedge Fund Research, Inc. that utilizes an objective rules-based methodology to diversify across hedge fund managers that have low correlations to traditional asset classes. This index is rebalanced quarterly and is passively investable. This is a U.S. dollar denominated index where the U.S. currency exposure is passively hedged back into Canadian dollars.

ICREIM/IPD Large Institutional All Property Index
An index maintained by the Institute of Canadian Real Estate Fund Managers / International Property Databank that measures the total return from the six largest Canadian peer funds, which individually have real estate portfolios valued greater than $1.5 billion.

Morgan Stanley Capital International Europe, Australasia, Far East Index
An index maintained by the MSCI Index Committee that is designed to measure developed public market equity performance, excluding the U.S. and Canada. As of December 2005, the index consisted of 21 developed market country indices representing approximately 85 per cent of the market value of securities listed in the included countries.

S&P/TSX Composite Index
An index maintained by the S&P/TSX Canadian Index Policy Committee that measures the return on the largest companies and trust units listed on the Toronto Stock Exchange.

Scotia Capital 91-day T-Bill Index
An index maintained by Scotia Capital that represents the performance of Government of Canada 91-day Treasury Bills.

Scotia Capital Universe Bond Index
An index maintained by Scotia Capital that tracks the performance of most marketable, domestically issued, Canadian bonds with terms to maturity of more than one year. This index comprises Canada's, provincial, municipal and AAA-through BBB-rated corporate issuers.

Standard & Poor's Composite 1500 Index
An index maintained by Standard & Poor's Index Committee that combines the S&P 500, S&P MidCap 400, and S&P SmallCap 600 indices to create a broad market portfolio representing approximately 90 per cent of the market value of U.S. public equities.

APPENDIX C:

Definitions of Terms Used in the Business Plan

Absolute Return Strategy
Absolute return strategies encompass a wide variety of investments with the objective of realizing positive returns regardless of the overall market direction. Investments in absolute return strategies are made through multi-hedge fund-of-funds and direct investments to increase strategy diversification.

Active Management
Managing the investments of a portfolio with the objective of outperforming the return of its benchmark. Active management generally takes two forms - security selection or asset allocation decisions. Security selection is the buying and selling of particular securities to earn a return above a market index. Asset allocation refers to changing asset class or sector weights to earn a return above what would be available from maintaining the asset class or sector weight in the benchmark.

Asset Allocation
The investment process by which the investment manager chooses or allocates funds among broad asset classes such as stocks and bonds.

Asset (or Investment) Class
Refers to a broad category of investments with similar characteristics (the typical asset classes are cash, stocks, bonds and real estate).

Benchmark
A standard against which performance is measured. Common benchmarks used in investment management are the Scotia Capital Universe Bond Index for Canadian fixed income, the S&P/TSX Composite Index for Canadian public equities, the S&P 1500 Index for U.S. public equities, among others.

Bond
A bond is a financial instrument representing a debt where the issuer (corporation or government) promises to pay to the holder a specific rate of interest over the life of the bond. On the bond's maturity date, the principal is repaid in full to the holder.

Capital Gain (or Capital Loss)
The market value received on the sale of an asset, which is higher (lower) than its purchase price (also called cost or book value). If an asset is bought for $50 and sold for $75, the realized capital gain or profit is $25.

Diversification
Diversification is a process of allocation of investment assets within an Asset Class and among asset classes. Diversification is intended to reduce risk.

Dividends
Earnings distributed to shareholders of a company, proportionate to their ownership interest.

Equities
Equities are synonymously called stocks or shares and represent an ownership interest in a company (could be either a public or private firm). Shareholders normally have voting rights and may receive dividends based on their proportionate ownership.

Fixed Income Securities
An investment that is required to pay a fixed interest rate at periodic intervals such as bonds, mortgages and debentures.

Inflation
Increases in the general price level of goods and services. Inflation is one of the major risks to investors over the long-term as savings may actually buy less in the future.

Investment Grade
An investment grade bond is rated a minimum of BBB (or equivalent) by a rating agency, with AAA being the highest grade. Bonds rated below BBB are generally classified as being speculative grade and carry higher levels of credit risk than investment grade bonds (i.e., they have a higher probability of default on interest or principal payments).

Liquidity
The ease with which an investor can buy or sell an investment at a fair market price.

Money Market Instruments
Debt instruments such as Treasury Bills or corporate paper with a maturity of less than one year.

Nominal Rate of Return
A measure of the earnings performance of a fund measured in current dollars.

Portfolio
A collection of investments owned by an investor.

Private Equity
An equity investment in a private (not publicly traded) company.

Private Income
A private investment that is structured to provide high current income. Examples of investment opportunities considered to be private income include infrastructure projects, bridge loans and corporate finance arrangements.

Real Rate of Return
The nominal rate of return minus the rate of inflation.

Realized/Unrealized
Terms generally used to describe capital gains or losses. A gain or loss is generally realized when an asset is sold; prior to sale the gain or loss is unrealized and it is only a potential or "paper" gain or loss.

Swaps
Financial agreements whereby counterparties agree to exchange the returns they earn on their respective assets. For example, an investor might swap the return from his bond portfolio for the returns of another investor's stocks and vice versa.

Timberland
Refers to investment in privately owned areas of woodland; that is, forested areas consisting of both hardwood and softwood species. When responsibly managed, timberland investments are a renewable and sustainable resource that responds to demand for lumber and paper products, and provides benefits such as diversification, an inflation hedge, and relatively high yield within the context of a portfolio.